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No. 89-1999

In the Supreme Court of the United States

OCTOBER TERM, 1990

DIEBOLD, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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17 pp

QUESTION PRESENTED

Whether petitioner's changing the characterization of its modular spare parts for automated teller machines from inventory to assets subject to depreciation, in order to claim investment tax credits and depreciation deductions with respect to those parts, constitutes a change in method of accounting for which the prior consent of the Commissioner of Internal Revenue is required under Section 446(e) of the Internal Revenue Code.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-8a) is reported at 891 F.2d 1579. The opinion of the Claims Court (Pet. App. 9a-53a) is reported at 16 Cl. Ct. 193.

JURISDICTION

The judgment of the court of appeals was entered on December 19, 1989. A petition for rehearing was denied on March 26, 1990 (Pet. App. 54a). The petition for a writ of certiorari was filed on June 22, 1990. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner began manufacturing automated teller machines (ATMs) and selling them to banks and other financial institutions in 1974. Petitioner also maintained and repaired the ATMs under service contracts with the ATM purchasers. Petitioner's ATMs were composed of several separate subassemblies or "modules," each of which performed a discrete function. This modular construction facilitated rapid on-site repairs: a malfunctioning module that could not be repaired quickly would be replaced with a functional module. The faulty module would then be repaired at petitioner's repair center and placed in the pool of spare service modules for use in future ATM repairs. Pet. App. 2a.

During the 1974-1979 period, petitioner accounted for the spare service modules as inventory, *i.e.*, as non-depreciable assets. In October 1980, petitioner filed amended federal income tax returns for 1976 and 1977, the years in issue (as well as for 1978 and 1979), claiming tax refunds resulting from depreciation deductions and investment tax credits based on treating the spare service modules as depreciable property instead of as inventory. The Internal Revenue Service (IRS) disallowed petitioner's refund claims. Pet. App. 2a-3a.

2. Petitioner then commenced this refund action in the United States Claims Court, contending that the spare service modules are properly accounted for as depreciable assets, not as inventory as petitioner had treated them on its original returns. The government moved for summary judgment on the ground that the change petitioner sought to make was a change of accounting method for which petitioner

had failed to request or obtain the prior consent of the Commisioner, as required by Section 446(e) of the Internal Revenue Code.[1]

The Claims Court granted the government's motion for summary judgment (Pet. App. 9a-53a). The court explained that, because the change in question affected the time at which petitioner would recover the cost of manufacturing the spare service modules, it amounted to a change in the treatment of a "material item," and hence of accounting method, within the meaning of Treas. Reg. § 1.446-1(e)(2)(ii)(a) (26 C.F.R.). The court then rejected petitioner's various proffered grounds for avoiding this conclusion. The court stated that petitioner's change was not simply the "correction of mathematical or posting errors," which would not require the consent of the Commissioner, but rather was a change that "drastically altered deduction timing" (Pet. App. 21a-22a). The court proceeded to reject petitioner's contention that Section 446(e) is not applicable whenever the original method of accounting being changed is incorrect (Pet. App. 22a-32a). The court also rejected petitioner's contentions that a taxpayer does not need consent to correct an accounting error in the first year in which it uses that method of accounting (*id.* at 32a-38a), that the policies of Section 446(e) would be frustrated by applying it to petitioner here (Pet. App. 38a-41a), that the audit report reflected the Commissioner's consent to the change (*id.* at 41a-46a), and that considerations of fairness required the Commissioner to allow the

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[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code (26 U.S.C.), as amended (the Code or I.R.C.).

change even though petitioner did not request a change of accounting method (*id.* at 46a-50a).[2]

3. The court of appeals affirmed (Pet. App. 1a-8a). It ruled that the change from inventory treatment to depreciation treatment satisfied the regulations' definition of a change in the treatment of a material item because it "involves the proper time for the inclusion of an item in income or the taking of a deduction" (*id.* at 6a, quoting Treas. Reg. § 1.446-1(e)(2)(ii)(a)). Further, the court specifically rejected petitioner's contention that it was merely correcting a "posting error," and stated that petitioner's "argument that it seeks to correct a substantive error independent of its choice of accounting procedures is simply wrong" (Pet. App. 6a). The court also agreed with the Claims Court that, even if petitioner had sought to change from an incorrect to a correct accounting method, that would still be a change in method of accounting requiring the Commissioner's prior consent (*id.* at 6a-7a).

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[2] In light of these legal conclusions, the court found it unnecessary to resolve the disputed issues whether petitioner's original method of inventory accounting was a permissible one and whether petitioner commenced this method in 1976 or, as the Commissioner contended, in 1974 (Pet. App. 50a-53a).

ARGUMENT

The court of appeals correctly held that petitioner's attempt to recharacterize its spare service modules as depreciable property, instead of nondepreciable inventory, was a change of accounting method for which the Commissioner's prior consent was required, without regard to whether the change was from an incorrect to a correct method of accounting. This holding is fully consistent with the governing statute and regulations, and it does not conflict with any decision of this Court or of another court of appeals. Accordingly, there is no reason for review by this Court.

1. Section 446(e) of the Code provides: "Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary." Treas. Reg. § 1.446-1(e) implements this provision and defines a change in accounting method in detail. Treas. Reg. § 1.446-1(e)(2)(ii)(a) provides in part as follows:

> A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. * * * A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. * * *

The regulation also provides that "correction of mathematical or posting errors," or the adjustment of items that do *not* involve the proper time for the inclusion of an item in income or the taking of a de-

duction, do not constitute changes of accounting method (Treas. Reg. § 1.446-1(e)(2)(ii)(b)). The question here is the application of these provisions to the particular facts of this case—namely, petitioner's decision to recharacterize its spare service modules as depreciable assets instead of inventory.

As both courts below concluded, the change at issue here—from inventory to depreciable assets—easily falls within the plain terms of the provisions of the regulations. Inventory accounting takes into account the cost of items of inventory in computing the cost of goods sold in a given year. See *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 545 (1979); *Commissioner* v. *Van Raden*, 650 F.2d 1046, 1048 n.1 (9th Cir. 1981). Treating an asset as depreciable property, on the other hand, permits the taxpayer to deduct the cost of the asset in increments over a period of years. See I.R.C. § 167. Changing from inventory to depreciable asset treatment, therefore, manifestly involves the proper time at which a deduction (or reduction of income) may be taken for the cost of the property. Thus, the change affects "the treatment of any material item," and accordingly constitutes a change of accounting method as defined in the regulations. Indeed, the regulations make clear that starting to depreciate an asset that previously had been treated as nondepreciable constitutes an accounting method change (Treas. Reg. § 1.446-1(e)(2)(ii)(b)):

> [F]or example, a correction to require depreciation in lieu of a deduction for the cost of a class of depreciable assets which has been consistently treated as an expense in the year of purchase involves the question of the proper timing of an item, and is to be treated as a change in method of accounting.

2. Petitioner seeks to avoid the plain import of the governing definition by arguing (Pet. 5-11) that when a taxpayer changes from an incorrect method of accounting to a correct one, Section 446(e) does not require that he obtain the prior consent of the Commissioner. This contention finds no support in the statute, and it is directly contrary to the terms of the regulation. Moreover, this contention has repeatedly been rejected by the courts of appeals.

Section 446(e) states that any change of accounting method must be approved in advance by the Commissioner, "[e]xcept as otherwise expressly provided in this chapter." Petitioner points to no provision in the Code that even arguably excludes the change in this case from the purview of Section 446(e), and therefore its contention is refuted by the plain statutory text. Moreover, the applicable regulation explicitly states that a taxpayer who wishes to change his method of accounting must secure the prior consent of the Commissioner "whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder" (Treas. Reg. § 1.446-1(e)(2)(i)). Indeed, several of the examples given in the regulation clearly identify the taxpayer's original method of accounting as one that is not permissible under the Code, but a change of the method is nonetheless identified there as a change that requires the Commissioner's approval. Treas. Reg. 1.446-1(e)(2)(iii), Examples 1, 6-8.[3] Thus, there can be no doubt that the governing regulation

[3] Moreover, the regulation's specific reference to a change in treatment of an asset from nondepreciable to depreciable describes the assets in question as depreciable, and thus also contemplates a change from an improper to a proper method of accounting. See Treas. Reg. § 1.446-1(e)(2)(ii)(b); page 6, *supra*.

has long required a taxpayer to obtain the Commissioner's consent before he changes from an impermissible or improper method of accounting to a permissible or proper one.

The courts of appeals have repeatedly recognized the validity of this aspect of the regulation. In *Witte* v. *Commissioner*, 513 F.2d 391, 394 (D.C. Cir. 1975), the court unequivocally rejected the position advanced by petitioner here as "contrary to the applicable Treasury regulations and subversive of the underlying purpose of section 446(e)'s consent requirement." The court explained the error of petitioner's approach as follows (*ibid.*):

> The purpose of the consent requirement is to enable the Commissioner to prevent distortions of income that often accompany changes in accounting methods by conditioning consent on the taxpayer's agreement to make correcting adjustments in his income tax payments. The danger of distortion of income detrimental to governmental revenues exists regardless of whether the change in method is from one proper method to another or from an improper method to a proper one. The consent requirement has as much vitality in the latter case as in the former.

The court's holding in *Witte* fully accords with the decisions of several other courts of appeals. See *United States* v. *Kleifgen*, 557 F.2d 1293, 1297 n.9 (9th Cir. 1977); *Ed Smithback Plumbing, Inc.* v. *United States*, 209 Ct. Cl. 743 (1976), adopting opinion of trial judge, 37 A.F.T.R.2d 486, 495-496 (1975); *Poorbaugh* v. *United States*, 423 F.2d 157, 163 (3d Cir. 1970); *American Can Co.* v. *Commissioner*, 317 F.2d 604, 606 (2d Cir. 1963), cert. denied, 375 U.S. 993 (1964); *Wright Contracting Co.* v. *Commissioner*, 316 F.2d 249, 254 (5th Cir.), cert.

denied, 375 U.S. 879 (1963); *Commissioner* v. *O. Liquidating Corp.*, 292 F.2d 225 (3d Cir.), cert. denied, 368 U.S. 898 (1961); *Broida, Stone & Thomas, Inc.* v. *United States*, 204 F. Supp. 841, 843 (N.D. W. Va.), aff'd, 309 F.2d 486 (4th Cir. 1962).[4]

3. Disregarding this consistent line of authority, petitioner contends (Pet. 5-11) that the decision below creates a conflict in the circuits. The cases relied upon by petitioner, however, are in no way inconsistent with the decision below. They do not purport to disagree with the rule that Section 446(e) is applicable even where the original method of accounting is incorrect. Rather, in those cases the courts concluded that there was no change in accounting method, based on facts substantially different from those here.

In *W. A. Holt Co.* v. *United States*, 368 F.2d 311 (5th Cir. 1966), for example, the court held that the

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[4] The Tax Court sometimes has not required the consent of the Commissioner to change from a clearly incorrect accounting method to a correct one, notwithstanding the stricter approach taken by the regulations and the courts of appeals. See *Southern Pacific Transportation Co.* v. *Commissioner*, 75 T.C. 497, 682 n.208 (1980). When the Tax Court's decisions in these cases have been appealed, however, they have been reversed. See *Witte* v. *Commissioner, supra*; *American Can Co.* v. *Commissioner, supra.* Moreover, the Tax Court has not consistently adhered to the position described in *Southern Pacific* and, more recently, seems to have abandoned it. For example, in *First National Bank of Gainesville* v. *Commissioner*, 88 T.C. 1069, 1085 (1987), the Tax Court stated that "[w]here the correction of an error results in a change in accounting method, the requirements of section 446(e) are applicable." See also, *e.g.*, *Wayne Bolt & Nut Co.* v. *Commissioner*, 93 T.C. 500, 510-512 (1989); *H. F. Campbell Co.* v. *Commissioner*, 53 T.C. 439, 447-448 (1969), aff'd, 443 F.2d 965 (6th Cir. 1971).

taxpayer's practice of taking bad debt deductions in respect of accounts receivable that were not, in fact, worthless was not a method of accounting. In *Schuster's Express, Inc.* v. *Commissioner*, 66 T.C. 588 (1976), aff'd, 562 F.2d 39 (2d Cir. 1977), the court held that the taxpayer's practice of deducting estimated insurance expenses in excess of the insurance expenses actually incurred did not amount to a method of accounting. The conclusions in both of these cases follow directly from the definition in the regulation. As we have noted (pages 5-6, *supra*), the adjustment of an item that does not involve the proper time for including an item in income or taking a deduction is not a change in method of accounting. Treas. Reg. § 1.446-1(e)(2)(ii)(b). The correction of the taxpayers' erroneous practices in both *Holt* and *Schuster's Express* plainly did not implicate the *timing* of deductions; the taxpayers had taken deductions to which they were not entitled *at any time.*

Here, by contrast, petitioner plainly incurred the cost of producing its spare service modules, and it was entitled to recover that cost ultimately through reductions in income. The issue implicated by the change from inventory to depreciable asset treatment is *when* the cost recovery would occur—upon sale or abandonment of the modules or, alternatively, in annual increments under a method of depreciation. Since the change at issue here does involve a matter of timing it manifestly falls within the regulatory definition of a change of accounting method.

Even more readily distinguishable from this case is *Mamula* v. *Commissioner*, 346 F.2d 1016 (9th Cir. 1965). That case does not address Section 446 or even discuss the question of a change of method of accounting. In *Mamula*, the taxpayer sold real prop-

erty on an installment basis and incorrectly took the position that he could report the gain on a "deferred basis," *i.e.*, that he did not have to report any gain at all until he had recovered the entire cost of the property. The IRS disallowed this treatment of the gain and required the taxpayer to recognize all of his gain in the year of the sale; the IRS thus declined to permit him to elect the installment method of reporting gain, which he clearly could have elected in the first instance. The court of appeals reversed, holding that the taxpayer's decision to report the sale income on a "deferred basis" should not be viewed as a binding election because it was set aside "[a]t the insistence of the government, not the taxpayer" (346 F.2d at 1019). Once the government had disallowed the taxpayer's original method of reporting the gain, the court held, the taxpayer should still be entitled to elect between the two permissible methods of reporting. That decision plainly has no relevance here, where the Commissioner did not disallow petitioner's inventory treatment of the spare service modules (and, indeed, has not contended that inventory treatment was impermissible (see Pet. App. 22a n.3)). Petitioner here chose to change its method of accounting, and the courts below correctly held that Section 446(e) required it to obtain the Commissioner's approval.[5]

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[5] Petitioner also cites (Pet. 10-11) two decisions decided under the predecessor of Section 446 contained in the 1939 Code. As the Claims Court explained (Pet. App. 24a-27a), those cases are not relevant here because the statutory scheme was different. The prior statute did not contain an express provision requiring the prior consent of the Commissioner for a change in accounting method, nor did the regulations thereunder define a change of the kind at issue here as affecting treatment of a "material item" that constitutes a method of accounting. See Section 29.41-2, Treasury Regulations 111

4. Petitioner's contention (Pet. 12-14) that this Court should grant certiorari because the decision below "has the potential for vastly expanding the Commissioner's power" (Pet. 12) is entirely without merit. The decision in this case works no change in the law; it simply applies the terms of an established regulation to a fact situation that is plainly governed by those terms. And, as we have noted (pages 8-9, *supra*), the decision is fully in accord with the decisions of several courts of appeals that have considered and rejected petitioner's position. The authority of the Commissioner to withhold consent to a change of accounting method, subject to review for abuse of discretion, has long been established by the text of Section 446(e). And, contrary to petitioner's implication (Pet. 14), the decision of the court of appeals does not restrict the right of taxpayers to file amended returns to correct errors, substantive or procedural, if the correction of the error does not rise to the level of a change of accounting method.[6] There is no reason for further review.

(1939 Code). In any event, those cases are distinguishable. In *Thompson-King-Tate, Inc.* v. *United States*, 296 F.2d 290 (6th Cir. 1961), the court concluded that the taxpayer had erred in the application of its established completed contract method of accounting; by correcting the error, it was not changing its accounting method. See *id.* at 294-295; Pet. App. 29a. Similarly, in *Beacon Publishing Co.* v. *Commissioner*, 218 F.2d 697, 701-702 (10th Cir. 1955), the court held that the taxpayer was not changing its method of accounting, but was merely correcting an error in the application of its existing accrual method of accounting.

[6] Petitioner errs in asserting (Pet. 13) that a recent revenue ruling demonstrates that "[t]he Internal Revenue Service has already begun to take advantage of the new power vested in it by the Federal Circuit." While the instant case, along with

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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AUGUST 1990

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many others, is cited in support of Rev. Rul. 90-38, 1990-18 I.R.B. 7, it plainly does not form an independent basis for the issuance of that ruling. Rather, the ruling is based on general principles under Section 446 long established by the applicable regulation and the case law. Indeed, the rulings recently revoked or modified by Rev. Rul. 90-38 were identified some years ago by the IRS's technical staff as "incorrect statements of the law." See G.C.M. 39,328 (June 8, 1984), *IRS Positions* [1984-1985 Transfer Binder] (CCH) ¶ 1610, at 5191, 5201.

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